



Signed and Filed: January 18, 2008

A handwritten signature in dark ink, appearing to read "T. E. Carlson", is written over a horizontal line.

THOMAS E. CARLSON  
U.S. Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT  
FOR THE NORTHERN DISTRICT OF CALIFORNIA

In re	)	Case No. 07-31580 TEC
	)	
NATIONAL FARM FINANCIAL	)	Chapter 11
CORPORATION, a California	)	
corporation,	)	
	)	
Debtor.	)	
	)	
	)	Adv. Proc. No. 07-3134 TC
NATIONAL FARM FINANCIAL	)	
CORPORATION, a California	)	
corporation,	)	
	)	
Plaintiff,	)	
	)	
vs.	)	
	)	
PSM HOLDING CORP., a New York	)	
corporation,	)	
	)	
Defendant.	)	
	)	

**MEMORANDUM DECISION RE DEBTOR'S REQUEST FOR PRELIMINARY INJUNCTION**

Debtor National Farm Financial Corporation (Debtor) is a holding company that owns all of the shares of Business Alliance Insurance Company (BAIC), an operating insurance carrier. Debtor's shares are held by the Chao Family Trust. Larry and Julie Chao are the trustees, and are also husband and wife. The trust can take

1 action only upon the approval of both trustees. Larry Chao is  
2 president and CEO of both Debtor and BAIC.

3 Debtor entered a written contract to sell its BAIC shares to  
4 PSM Holding Corp. (PSM). When Debtor refused to close the sale,  
5 PSM sued Debtor, BAIC, and Larry Chao in the Central District of  
6 California. After a 15-day jury trial, the district court awarded  
7 PSM a \$43 million judgment against Debtor, Larry Chao, and BAIC  
8 (the Judgment). The district court reduced the Judgment to \$40  
9 million, but otherwise denied defendants' post-trial motions.

10 Unable to post a bond to stay the Judgment pending appeal,  
11 Debtor filed a chapter 11 petition on December 5, 2007. Larry Chao  
12 filed a chapter 11 petition on January 7, 2008. Because it is an  
13 insurance company, BAIC is not eligible for relief under the  
14 Bankruptcy Code. § 109(b)(2).<sup>1</sup> In the present proceeding, Debtor  
15 seeks to have this court enjoin PSM from enforcing the Judgment  
16 against BAIC, on the basis that such enforcement would unduly  
17 interfere with Debtor's ability to reorganize.

18 Prior decisions authorize a bankruptcy court to enjoin  
19 creditor action against the chapter 11 debtor's subsidiary that is  
20 itself unable to seek bankruptcy protection because it is an  
21 insurance company. See, e.g., In re Equity Funding Corp. of  
22 America, 396 F.Supp. 1266 (C.D. Cal. 1975). Whether such relief is  
23 appropriate turns upon application of the familiar four-part test  
24 for injunctive relief:

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28 <sup>1</sup> All statutory references are to the United State Bankruptcy  
Code, Title 11, United States Code, unless otherwise noted.

1 (1) a strong likelihood of success on the merits, (2) the  
2 possibility of irreparable injury to plaintiff if  
3 preliminary relief is not granted, (3) a balance of  
4 hardships favoring the plaintiff, and (4) advancement of  
5 the public interest (in certain cases). Alternatively, a  
6 court may grant the injunction if the plaintiff  
7 demonstrates *either* a combination of probable success on  
8 the merits and the possibility of irreparable injury or  
9 that serious questions are raised and the balance of  
10 hardships tips sharply in his favor.

11 Soldius Networks, Inc. v. Excel Innovations, Inc. (In re Excel  
12 Innovations, Inc.), 502 F.3d 1086, 1093 (9th Cir. 2007)

13 (parentheses and italics in original). In this particular context,  
14 the likelihood of prevailing on the merits refers to the likelihood  
15 that Debtor will be able to confirm a plan of reorganization.

16 This chapter 11 is in substance a two-party case between PSM  
17 and Debtor. Debtor scheduled only two claims. The first is the  
18 \$40 million Judgment. The other is a \$300,000 claim by the  
19 attorneys who represented Debtor in the PSM litigation. Both are  
20 general unsecured claims. Debtor states that Julie Chao also  
21 asserts a claim for the harm to her beneficial interest in the  
22 family trust caused by the acts of the officers and directors that  
23 gave rise to the Judgment.

#### 24 **A. Likelihood of Confirming a Plan**

25 Debtor has not shown a strong likelihood of confirming a plan.  
26 Debtor can confirm a plan in which its shareholders retain an  
27 interest in the BAIA shares only if general unsecured creditors  
28 accept the plan. § 1129(b)(2)(B). A plan cannot be confirmed over  
the objection of PSM, because it holds more than one-third of the  
general unsecured claims. § 1126(c). Debtor asserts that it will  
be able to confirm a plan by subordinating the Judgment to the  
claims of Julie Chao and the attorneys under section 510 of the

1 Bankruptcy Code. As explained below, Debtor's theory is  
2 unsupported by law.

3 Debtor first argues that the Judgment should be subordinated  
4 under section 510(b), because it arises out of the purchase of a  
5 security of Debtor or an affiliate of Debtor. While the Judgment  
6 did arise out of Debtor's breach of contract to sell the shares of  
7 its affiliate BAIA, section 510(b) does not require subordination  
8 to the creditors of Debtor. The statute requires a claim arising  
9 from the purchase of BAIA shares to be given the same priority as  
10 the BAIA shares themselves. The BAIA shares are not  
11 subordinated to Debtor's creditors because to Debtor they represent  
12 an asset, like a vehicle or a building. Each of the cases relied  
13 upon by Debtor involves the very different circumstance in which  
14 the claimant had purchased shares of the *debtor itself*. In that  
15 circumstance, section 510(b) requires subordination to creditors of  
16 the debtor, to prevent parties who bargained only for an equity  
17 stake in debtor from elevating themselves to parity with creditors  
18 who justly expected to be paid in full before equity holders  
19 received any value. American Broadcasting Systems, Inc. v. Nugent  
20 (In re Betacom of Phoenix, Inc.), 240 F.3d 823, 828-31 (9th Cir.  
21 2001); Falcon Capital Corp. Shareholders v. Osborne (In re THC  
22 Financial Corp.), 679 F.2d 784, 785-87 (9th Cir. 1982). In the  
23 present case, the language and purpose of section 510(b) relate  
24 only to whether the Judgment is subordinated to the claims of  
25 creditors of BAIA. Because BAIA is not entitled to seek bankruptcy  
26 protection, the claims of those creditors are not before this  
27 court.

1 Debtor next argues that the Judgment should be subordinated to  
2 Julie Chao's claim, pursuant to section 510(c) of the Bankruptcy  
3 Code. This argument is predicated on the assumption that the  
4 Judgment is subject to rescission, because the contract upon which  
5 it is based was not approved by Debtor's shareholders, as required  
6 by California Corporations Code section 1001.

7 From this premise, Debtor first contends that the Judgment  
8 should be subordinated, because payment of the claim would violate  
9 a statute. La Grand Steel Products Co. v. Goldberg (In re Poole,  
10 McGonigle & Dick, Inc.), 796 F.2d 318, 322-24 (9th Cir.), *amended*  
11 *by* 804 F.2d 576 (9th Cir. 1986). That decision does not support  
12 subordination in the present case. The statute in question in  
13 Poole prohibited the repurchase of shares by an insolvent  
14 corporation. Subordination in that circumstance served the same  
15 purpose cited by the cases interpreting section 510(b): to prevent  
16 a party that bargained only for an equity position from elevating  
17 itself to parity with creditors. Id. at 323. Debtor cites no  
18 authority for the proposition that failure to secure the  
19 shareholders' approval of a contract vitiates a money judgment for  
20 breach of that contract. The Solorza decision holds only that a  
21 sale not approved by shareholders is not void, because the  
22 shareholders may later decide to ratify it. Solorza v. Park Water  
23 Co., 86 Cal.App.2d 653 (1948). Section 208(b) of the Corporations  
24 Code suggests that lack of required shareholder approval does not  
25 relieve the corporation from monetary liability under a contract.  
26 That section provides that a contract made by an officer with  
27 actual or apparent authority binds the corporation, "except as the  
28 board's authority is limited by law other than this division. . .

1 ." Sections 208 and 1001 are both in Division 1 of the  
2 Corporations Code. Thus, any failure to comply with section 1001  
3 is not a limitation imposed by law "other than this division."  
4 Furthermore, subsection (a) of section 208 suggests that the  
5 shareholder's remedies are to sue to enjoin closing of the sale, or  
6 to sue the responsible officers and directors for breach of duty.

7 Debtor contends that subordination is also appropriate under  
8 section 510(c), because PSM engaged in improper litigation tactics  
9 by not joining Julie Chao as a party in the district court action.  
10 Debtor cites no authority for this contention. Furthermore, to the  
11 extent that Debtor has any standing to raise this issue, Debtor has  
12 not explained why it did not do so in the district court. It is  
13 also worthy of note that the district court permitted PSM to argue  
14 that "NFFC was not handled by the Chaos in such a way as to be  
15 considered a separate legal entity from BAIC" and stated "it is up  
16 to the jury to determine whether Mr. Chao's signature on the  
17 [contract] is sufficient to bind BAIC and NFFC and himself."  
18 Fineman Decl., Exh. E at 9:18-20; 8:21-23.

19 The one claim that would appear to be subject to subordination  
20 is that of Julie Chao. Because she holds (indirectly) only an  
21 equity interest in Debtor, any claim for damage to that equity  
22 interest must be subordinated to the claims of Debtor's creditors.  
23 See Betacom, supra, 240 F.3d at 828-31.

24 It is clear from the above that PSM holds more than one-third  
25 in amount (indeed virtually all) of the general unsecured claims  
26 against Debtor, and that PSM can therefore block confirmation of  
27 any plan that provides for Debtor's shareholders to retain any  
28

1 interest in the shares of BAIC. § 1129(b)(2)(B). Thus, Debtor has  
2 not shown a strong likelihood of confirming a plan.

3  
4 **B. Balance of Hardships**

5 Nor has Debtor shown that the balance of hardships tips  
6 sharply in its favor. Debtor's most legitimate interest is in  
7 having some effective remedy if the Judgment is reversed. Debtor  
8 seeks to do so by staying all enforcement of the Judgment during  
9 what may be a protracted appeal. There are alternate remedies that  
10 would not deny PSM all benefits of its Judgment, and at the same  
11 time would preserve for Debtor an effective remedy should it  
12 prevail on appeal. This court, for instance, could condition  
13 relief from stay permitting PSM to hold and vote the shares of BAIA  
14 on PSM's not transferring those shares, or seizing or transferring  
15 assets of BAIC out of the ordinary course of business, pending the  
16 outcome of the appeal. It is unlikely that BAIA itself would be  
17 dismembered in such a setting. The duty of the Insurance  
18 Commissioner to protect BAIA's policyholders to a large extent  
19 requires the protection of BAIA itself. If there arises some  
20 specific threat to the continued viability of BAIA, this court can  
21 always revisit whether the broad injunctive relief presently sought  
22 is appropriate. Debtor's desire to keep control of BAIA during the  
23 appeal does not outweigh PSM's interest in enjoying the profits of  
24 BAIA during that period.

25  
26 **C. Irreparable Harm and Public Interest**

27 This court assumes without deciding that Debtor has no  
28 adequate legal remedy and may suffer irreparable harm if injunctive

1 relief is not granted. It appears that public policy  
2 considerations are neutral. The relevant public interest to be  
3 protected is that of the policy holders of BAIC, and they will be  
4 protected by the Insurance Commissioner.

5

6 **CONCLUSION**

7 Because Debtor has not shown a likelihood of prevailing on the  
8 merits, or that the balance of hardships justifies the long-term  
9 imposition of the broad relief presently sought, such relief will  
10 be granted only on a temporary basis. Thus, the temporary  
11 restraining order entered on December 6, 2007 will remain in effect  
12 through February 8, 2008 or until a further order is entered,  
13 whichever comes first. The court will hold a status conference  
14 regarding this action on January 28, 2008 at 10:30 a.m. The court  
15 respectfully requests counsel for the Insurance Commissioner to  
16 attend and participate.

17 **\*\*END OF MEMORANDUM DECISION\*\***

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